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IN THE
SUPREME COURT OF THE UNITED STATES
OCTOBER TERM, 1998

CALIFORNIA PUBLIC EMPLOYEES' RETIREMENT SYSTEM AND FLORIDA STATE BOARD OF ADMINISTRATION,
Petitioners,

v.

PAUL FELZEN, *et al.*,
Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF OF *AMICUS CURIAE* COUNCIL OF INSTITUTIONAL INVESTORS IN SUPPORT OF PETITIONERS

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QUESTION PRESENTED

Whether a shareholder who, pursuant to Federal Rule of Civil Procedure 23.1, appears in federal district court and presents objections to a proposed dismissal or settlement of a derivative action, must also intervene pursuant to Federal Rule of Civil Procedure 24 to appeal an adverse decision.

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BRIEF OF *AMICUS CURIAE* COUNCIL OF INSTITUTIONAL INVESTORS IN SUPPORT OF PETITIONERS

INTEREST OF *AMICUS CURIAE*[1]

The Council of Institutional Investors (the "Council") is an organization of public, Taft-Hartley and corporate pension funds that seeks to address investment issues that affect the security of pension plan assets by encouraging institutional investors to take an active role in protecting those assets. The Council was founded in 1985 in response to controversial takeover activities that threatened the financial interests of

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[1] Pursuant to Rule 37.6 of the Rules of this Court, *amicus* states that no counsel for a party authored this brief in whole or in part, and no person or entity other than *amicus* and their counsel made any monetary contribution to the preparation or submission of this brief. Pursuant to Rule 37.3, *amicus* states that petitioners and respondents have granted consent to file this brief.

pension fund beneficiaries. Since that time, the Council has grown to over 100 members who control pension assets in excess of $1 trillion and represent millions of plan beneficiaries and participants. The Council is recognized as a significant voice for investors on issues of corporate governance, executive compensation, and corporate accountability to shareholders, see, *e.g.*, *In re Wells Fargo Sec. Litig.*, 991 F. Supp. 1193, 1198 (N.D. Cal. 1998), and consistently has been a proponent of meaningful shareholder participation in major decisions that affect corporate viability.

The interests of the Council are directly implicated by this case. Consistent with its view that participation by shareholders in corporate decision making generally provides substantial benefits, the Council believes that such participation is essential to judicial assessment of the fairness of voluntary settlements in shareholder derivative actions. The Council believes that the decision below, if affirmed, would erect a substantial and unnecessary barrier to full participation by objecting shareholders in the review of proposed settlements in cases where such participation is most needed.

SUMMARY OF ARGUMENT

Shareholder objectors who appear before district courts to voice concerns regarding proposed settlements in shareholder derivative actions under Federal Rule of Civil Procedure 23.1 ("Rule 23.1") play an important role in policing the fairness of such settlements and should not be required to intervene as named plaintiffs to secure a right to appeal the rejection of their objections. Rule 23.1, settled precedent, and substantial legal commentary confirm that shareholder derivative actions are subject to unusual conflicts of interest that frequently undermine confidence that a proposed voluntary compromise is in the best interests of the corporation. The requirement of mandatory

"notice" to shareholders of a proposed settlement and their subsequent participation in the settlement process provides an important check against collusive or otherwise improper settlements. Indeed, when objecting shareholders' views have been given studied consideration, they have resulted in substantial modifications of settlement proposals that provided tangible benefits to the corporation. All too often, however, valid shareholder objections may be ignored or improperly rejected by district courts that are denied a full adversarial presentation by the named parties and operating under a strong incentive to approve quick settlements.

Under these circumstances, appellate review is an essential component of effective shareholder participation. It provides a direct avenue for correcting district court errors and a strong incentive for district courts to consider shareholder objections fully and fairly in the first instance. In contrast, denying or discouraging appeals by objecting shareholders would insulate erroneous decisions from review and would strengthen the incentive of district courts to disregard shareholder objections. A requirement of intervention under Federal Rule of Civil Procedure 24 would produce precisely these untoward effects. If such a requirement were imposed, some shareholder objectors would be unable to intervene and would therefore be shut off from appellate review. The remainder would be saddled with substantial additional costs and burdens that create no corresponding benefit to the litigation. Imposition of such a requirement would thus limit participation by shareholder objectors and thereby undermine the fairness of these settlements.

ARGUMENT

I. OBJECTING SHAREHOLDERS PLAY A VALUABLE ROLE IN ENSURING THE FAIRNESS AND INTEGRITY OF SETTLEMENTS IN SHAREHOLDER DERIVATIVE LITIGATION.

Rule 23.1 governs the conduct of derivative actions by shareholders in federal courts and provides, in pertinent part:

> The derivative action may not be maintained if it appears that the *plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association*. The action shall not be dismissed without the approval of the court, and *notice of the proposed dismissal or compromise shall be given to shareholders* or members in such manner as the court directs.

Id. (emphasis added). As the language of Rule 23.1 confirms, its drafters were aware that shareholder derivative actions are susceptible to conflicting and divergent interests arising between the named plaintiff (or plaintiff's counsel) and the corporation (or similarly situated shareholders) on whose behalf the named plaintiff purports to act. These concerns are amplified in the context of voluntary settlements. When derivative claims are compromised, the suing stockholder may face strong financial incentives to "sell out" the interests of the corporation in return for "payments from corporate assets" to plaintiff's counsel, who often act as the controlling force in derivative litigation. *Cohen* v. *Beneficial Indus. Loan Corp.*, 337 U.S. 541, 548 (1949). To police that potential for abuse, Rule 23.1 requires district court approval of any such settlement and provides that notice of a proposed compromise "shall" be provided to shareholders

before the district court considers the merits of the settlement proposal. The notice requirement is designed to ensure that settlements will not be approved without giving shareholders an opportunity to object. Such objections provide an important corrective to the often considerable momentum behind proposed derivative settlements and frequently result in substantial enhancements to the fairness and value of such settlements.

A. The Settlement of Shareholder Derivative Actions Is Fraught With Potential for Conflict of Interest and Unfairness.

From the time of its earliest recognition in the United States, both the relative merits and the potential abuses of shareholder derivative litigation have been the subject of discussion by courts, legislatures, and legal commentators. As this Court explained nearly a half century ago, the shareholder derivative suit arose at a time when "[c]orporate laws were lax and were not self-enforcing, and stockholders, in face of gravest abuses, were singularly impotent in obtaining redress of abuses of trust." *Cohen*, 337 U.S. at 547-48. Responding to this void in legal remedies, "[e]quity came to the relief of the stockholder, who had no standing to bring civil action at law against faithless directors and managers," *id.* at 548, by allowing individual shareholders "to bring suit to enforce a corporate cause of action against officers, directors, and third parties," *Kamen* v. *Kemper Fin. Servs.*, 500 U.S. 90, 95 (1991) (internal quotation marks omitted). By placing litigation authority in the hands of the individual shareholder, the derivative action became "the chief regulator of corporate management and has afforded no

small incentive to avoid at least grosser forms of betrayal of stockholders' interests." *Cohen*, 337 U.S. at 548.[2]

As the *Cohen* Court also noted, however, "the remedy itself provided opportunity for abuse, which was not neglected." *Id.* Enabling individual shareholders to "represent" and act on behalf of the corporation and other shareholders created the risk that the interests of the named plaintiff shareholders would diverge from the interests of the corporation and the other (*de facto* party) shareholders. In some cases, the individual plaintiff could "becom[e] faint hearted prior to the litigation's completion and would be willing to settle the action even though it might not be in the best interests of all concerned." 7C Charles Alan Wright *et al.*, *Federal Practice & Procedure* § 1839, at 177 (1986) (citing *Webster Eisenlohr, Inc.* v. *Kalodner*, 145 F.2d 316, 320 (3d Cir. 1944)).

In the worst cases, the shareholder plaintiff might enter into "secret settlements in which any wrongs to the general body of share owners were compounded by the suing stockholder, who

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[2] *See also* 13 William Meade Fletcher, *Cyclopedia Corporations* § 5940, at 26 (1995) ("The derivative proceeding developed as an equitable device to enable shareholders to enforce a corporate right against faithless officers and directors . . . that the corporation had either failed or refused to assert on its own"); Ralph C. Ferrara *et al.*, *Shareholder Derivative* Litigation § 1.03, at 1-14 (1995) ("Equity came to the relief of the stockholder, [and] . . . allowed him to step into the corporation's shoes and seek, on behalf of the corporation, the restitution he could not demand on his own."); Bert S. Prunty, *The Shareholders' Derivative Suit: Notes on Its Derivation*, 32 N.Y.U. L. Rev. 980, 980 (1957) ("The story of the derivative suit in its infancy and adolescence is that of the lawmakers' response to recognized misuse of economic organizations viewed against popularly accepted standards of business conduct. The shareholders' right to command a judicial forum comes in answer to a demonstration of need.").

was mollified by payments from corporate assets." *Cohen*, 337 U.S. at 548. As Judge Friendly explained:

> The plaintiff stockholders . . . have every incentive to accept a settlement that runs into high six figures or more regardless of how strong the claims for much larger amounts may be . . . . [A] juicy bird in the hand is worth more than the vision of a much larger one in the bush, attainable only after years of effort not currently compensated and possibly a mirage.

Alleghany Corp. v. *Kirby*, 333 F.2d 327, 347 (2d Cir. 1964) (Friendly, J., dissenting), *aff'd en banc by an equally divided court*, 340 F.2d 311 (2d Cir. 1965). Given these dynamics, special care is warranted in the conduct and oversight of derivative actions "to prevent plaintiffs from selling out their fellow shareholders." *Burks* v. *Lasker*, 441 U.S. 471, 485 n.16 (1979).[3]

The potential for collusion, conflict of interest or agency problems is especially acute in derivative litigation because of the unusual degree to which plaintiff's counsel, rather than the plaintiff, controls and directs the course of such litigation. See *Greenfield* v. *Villager Indus., Inc.*, 483 F.2d 824, 832 n.8 (3d Cir. 1973) ("[C]ounsel for the class representative and not the

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[3] *See also* 7C Charles Alan Wright *et al.*, *Federal Practice & Procedure* § 1839, at 177 (1986) ("Special caution is warranted in the context of derivative suits inasmuch as plaintiff is affecting a right that belongs to the corporation."); 13 William Meade Fletcher, *Cyclopedia Corporations* § 6020, at 303 (1995) ("The requirement of court approval is intended to protect the interests of other shareholders . . . by prohibiting derivative plaintiffs . . . from settling with defendants for their own personal interests.").

named parties . . . direct and manage these actions").[4] Indeed, "[o]ne of the risks flowing from shareholders' difficulty in monitoring derivative litigation is that plaintiffs' counsel and the defendants will structure a settlement such that the plaintiffs' attorneys' fees are disproportionate to any relief obtained for the corporation" and thereby "settle in a manner adverse to the interests of the plaintiffs by exchanging a low settlement for high fees." *Bell Atlantic Corp.* v. *Bolger*, 2 F.3d 1304, 1310 (3d Cir. 1993). Moreover, in a derivative action, "both sides have a right to be reimbursed their legal expenses when there is a settlement, but not when there is an adverse judgment. These rules obviously create strong pressure for settlement and explain why even a plainly frivolous action may sometimes be settled." John C. Coffee, Jr., *The Unfaithful Champion: The Plaintiff as Monitor in Shareholder Litigation*, 48 Law & Contemp. Probs. 5, 24 (1985).[5]

Commentators agree that such conflicts of interest create the "risk that the representative plaintiff will collude with the defendant to forgo the derivative claims in exchange for a settlement that is only favorable to the representative plaintiff

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[4] *See* Daniel R. Fischel & Michael Bradley, *The Role of Liability Rules and the Derivative Suit in Corporate Law*, 71 Cornell L. Rev. 261, 271 & n.26 (1986) (noting that the "real party in interest is the attorney"); *cf.* Deborah L. Rhode, *Class Conflicts in Class Actions*, 34 Stan. L. Rev. 1183, 1203 (1982) ("[A]s a practical matter, once a class is certified, named plaintiffs generally are neither highly motivated nor well situated to monitor the congruence between counsel's conduct and class preferences.").

[5] *See also Saylor* v. *Lindsley*, 456 F.2d 896, 900 (2d Cir. 1972) (noting fact that "[a] relatively small settlement may well produce an allowance bearing a higher ratio to the cost of the work than a much larger recovery obtained only after extensive discovery, a long trial and an appeal," thereby creating the danger that a plaintiffs' attorney will settle a derivative claim for less than its expected value in return for this proportionately higher fee "allowance").

and his or her attorneys." 5 *Moore's Federal Practice* § 23.1.10[2][a], at 23.1-58 (1998); see also 7C Charles Alan Wright *et al.*, *Federal Practice & Procedure* § 1839, at 191 ("[T]he Court should be on the lookout for signs of bad faith or collusion among the parties to the proposed settlement."). As one commentator described the problem:

> [E]ffective control is almost entirely in the hands of the attorney. The most obvious examples of attorney control are class actions and shareholder derivative suits, in which the named plaintiff figures only in a symbolic capacity. Such litigation is almost always brought by entrepreneurial lawyers in hopes of obtaining an award of attorney's fees. The attorney exercises virtually plenary control over the litigation, including the decision whether to settle.

Geoffrey P. Miller, *Some Agency Problems in Settlement*, 16 J. Legal Stud. 189, 213-14 (1987); see also Ralph K. Winter, *Paying Lawyers, Empowering Prosecutors, and Protecting Managers: Raising the Cost of Capital in America*, 42 Duke L.J. 945, 948 (1993) ("[P]laintiffs [in derivative and class actions] are generally figureheads . . . because the real incentive for bringing such actions is the quest for attorney's fees.").

Assumption of control over the litigation by plaintiffs' attorneys creates an additional risk in the context of settlement of a shareholder derivative suit because "[t]here can be no blinking at the fact that the interests of the plaintiff in a stockholder's derivative suit and of his attorney are by no means congruent." *Saylor* v. *Lindsley*, 456 F.3d 896, 900 (2d Cir. 1972). The risks faced by plaintiff and his attorney in proceeding to trial vary substantially because "[f]or the plaintiff, a defendant's judgment may mean simply the defeat of an expectation, often of relatively small amount; for his lawyer it

can mean the loss of years of costly effort by himself and his staff." *Id.* at 900-01. Commentators and scholars uniformly acknowledge this substantial danger of conflicting interests between shareholder plaintiffs and their counsel in the settlement context.[6]

The danger that a proposed settlement will not be in the best interests of the corporation, or even of the named plaintiffs, is further threatened because, as federal legislators have recognized, such cases increasingly are dominated by a small cartel of law firms that recruit "[p]rofessional plaintiffs who own a nominal number of shares in a wide array of public companies" and have no real interest in monitoring their attorney's litigation decisions. See Private Securities Litigation Reform Act of 1995, H.R. 104-98, at 32, *reprinted in* 1995 U.S.C.C.A.N. 679, 731; see also *In re Urcarco Sec. Litig.*, 148 F.R.D. 561, 563 (N.D. Tex. 1993) (noting that plaintiffs "have among their ranks one of the unluckiest and most victimized investors in the history of the securities business"); Deborah A. Demott, *Shareholder Derivative Actions* § 1.05, at 1-13 ("A striking feature of derivative litigation in the post-Depression era is the frequency with which the same plaintiffs make their appearance.").

For these reasons, the settlement of shareholder derivative actions must be closely monitored to ensure that the terms of

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[6] *See* Deborah A. Demott, *Shareholder Derivative Actions* § 7.05, at 7-27 (1994) ("The potential divergence in interests between the plaintiff and the plaintiff's attorney is most likely to materialize in the settlement context."); John C. Coffee, Jr., *Understanding The Plaintiff's Attorney: The Implications of Economic Theory for Private Enforcement of Law Through Class and Derivative Actions*, 86 Colum. L. Rev. 669, 677-78 (1986) (arguing that the client in a derivative suit "generally has only a nominal stake in the outcome of litigation" and cannot closely monitor and control his attorney's conduct).

the proposed settlements are fair and meaningful, and not the product of improper collusion or conflicts of interests.

B. Objecting Shareholders Are Essential to Ensuring Fairness in Derivative Settlements.

Rule 23.1 provides two institutional safeguards designed to protect shareholders' interests from the acute potential for abuse inherent in derivative settlements: (1) district court approval of settlements, and (2) the opportunity for shareholders to raise objections to the proposed settlement.[7] Although the requirement of district court approval stands as a bulwark against improper settlement of derivative actions, Rule 23.1 recognizes that the district court's judgment should be informed by the views of shareholders who have a concrete stake in the resolution of the derivative action. As this Court has recognized, the *dual* requirements of district court approval and notice to shareholders are "intended to prevent plaintiffs from selling out their fellow shareholders," *Burks*, 441 U.S. at 485 n.16, and to prevent circumstances "where the action would disserve the legitimate interests of the company or its shareholders," *Daily Income Fund, Inc.* v. *Fox*, 464 U.S. 523, 532 n.7 (1984).

Thus, under Rule 23.1, the district court has a duty to determine whether the proposed compromise reasonably protects the interests of the corporation and its shareholders. See, *e.g.*, *Girsh* v. *Jepson*, 521 F.2d 153, 157 (3d Cir. 1975) (holding that the district court has a responsibility to assess the interests of the corporation when reviewing a proposed

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[7] *See* Fed. R. Civ. P. 23.1 ("The action shall not be dismissed without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.").

compromise). There are institutional reasons, however, why a district court may be poorly situated to fulfill this duty on its own.

First, the parties to the proposed settlement are unlikely to present "an unbiased portrayal of the merits of the derivative claims." *In re Oracle Sec. Litig.*, 829 F. Supp. 1176, 1185 (N.D. Cal. 1993). Indeed, "[t]he effort to obtain court approval entails the suspension, if not the termination, of hostilities" thereby depriving the district court of "the full benefit of the adversarial process." *Bolger*, 2 F.3d at 1310. The "presentation of plaintiffs' counsel [may be] biased because the settlement offers them a substantial fee, regardless of the benefit conferred on the corporation and its shareholders," while the "presentation on behalf of the [defendants may be] similarly biased in favor of settlement, because the settlement absolves them of liability without requiring them to part with any return consideration." *Oracle*, 829 F. Supp. at 1185. As a result, rather than providing to the district court a full and fair airing of issues occasioned by the settlement, "plaintiffs' attorneys' and defendants' interests coalesce and mutual interest may result in mutual indulgence" whereby the parties "spotlight the proposal's strengths and slight its defects." *Bolger*, 2 F.3d at 1310.[8]

Second, in considering a settlement proposal, a district court may have relatively limited knowledge of the underlying

[8] "Once a settlement is agreed, the attorneys for the plaintiff stockholders link arms with their former adversaries to defend their joint handiwork." *Alleghany Corp.*, 333 F.2d at 346-48 (Friendly, J., dissenting); *see also* Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2066 (1995) (arguing that district court "settlement hearings typically are not adversarial in character").

action, derived solely from the pleadings and the few briefs that may have been filed prior to settlement discussions. This lack of information makes it difficult for the district court to assess whether the proposed settlement is in the best interests of the corporation. Accordingly, settled precedent prohibits a district court from approving a settlement based "solely on the advice of the attorneys before it." 7C Charles Alan Wright *et al.*, *Federal Practice & Procedure* § 1839, at 186; see also *Greenspun* v. *Bogan*, 492 F.2d 375, 378 (1st Cir. 1974) ("It is well established that a court should not merely rubber stamp whatever settlement is proposed by the parties to a shareholder derivative action."); *Cohen* v. *Young*, 127 F.2d 721, 725 (6th Cir. 1942) ("The rule provides for notice to shareholders . . . in order that the court may have the benefit of that broader information.").

Third, there is a strong institutional bias in favor of settlement. Many courts proceed "from the familiar axiom that a bad settlement is almost always better than a good trial," and therefore may pay inadequate attention to shareholder objectors. *In re Warner Communications Sec. Litig.*, 618 F. Supp. 735, 740 (S.D.N.Y. 1985), *aff'd*, 798 F.2d 25 (2d Cir. 1986). Because "judges generally feel pressured to move their dockets," they have an interest in approving settlements that is at odds with their duty to carefully consider objections and closely scrutinize the fairness of a settlement. Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investors Can Reduce Agency Costs in Securities Class Actions*, 104 Yale L.J. 2053, 2067 (1995); see *Girsh*, 521 F.2d at 157 (reversing district court where objector denied the ability to develop and present her objections to the settlement proposal). Empirical studies reflect that the median lengths of fairness hearings in the two districts for which data were available were, respectively, 38 and 40 minutes. John C. Coffee, Jr., *Class Wars: The Dilemma of the Mass Tort Class*

Action, 95 Colum. L. Rev. 1343, 1348 & n.14 (1995) (arguing that empirical evidence suggests that "courts have little ability or incentive to resist [proposed] settlements"). The typical brevity of these hearings "seems inconsistent with careful judicial scrutiny of the settlement's fairness," *id.* at 1348 n.14, or of the often complex issues raised by objections.

The choices and incentives faced by the district court are straightforward:

> Judges' calendars are crowded with cases, and despite various reform efforts, the workload only seems to increase. If the judge approves the settlement, the result will be to remove a potentially complex and time-consuming case from the judge's calendar; if she rejects it she faces a substantial probability of further litigation.

Jonathan R. Macey & Geoffrey P. Miller, *The Plaintiffs' Attorney's Role in Class Action & Derivative Litigation: Economic Analysis and Recommendations for Reform*, 58 U. Chi. L. Rev. 1, 45-46 (1991). As a result, for some district courts, "settlement hearings are typically pep rallies jointly orchestrated by plaintiffs' counsel and defense counsel" where the district courts "engage in paeans of praise for counsel or lambaste anyone rash enough to object to the settlement." *Id.* at 46-47.

These problems explain why shareholder objectors "play an important role by giving courts access to information on the settlement's merits," and help to compensate for the institutional weaknesses that can blind the district court to an unfair settlement. *Bolger*, 2 F.3d at 1310; see also Deborah A. Demott, *Shareholder Derivative Actions* § 7:01, at 7-4 ("[O]bjectors to the settlement . . . may call the court's attention

to deficiencies that are not likely to be highlighted by the settlement's proponents."); *cf.* Federal Judicial Center, *Empirical Study of Class Actions in Four Federal District Courts: Final Report to the Advisory Committee on Civil Rules* 58 (1996) ("Objections represent an outside source of information about the substance of the settlement and its impact on class members. The settling parties at this stage have little or no incentive to present negative information about the settlement, so objections from class members and others may be a crucial source of information about defects in the settlement."). Indeed, even where there is little or no response by shareholder objectors, that inaction itself provides the court with additional information regarding the settlement's fairness. See *In re Chambers Dev. Sec. Litig.*, 912 F. Supp. 822, 841 (W.D. Pa. 1995) ("The mild response of the class is a factor in favor of settlement on the terms proposed.").[9]

Thus, it is not surprising that the efforts of non-party shareholder objectors in a wide variety of cases have resulted "in significant improvement of the settlement." William L. Cary & Melvin A. Eisenberg, *Corporations* 1057 (1988). For example, in *In re Pacific Enters. Sec. Litig.*, 47 F.3d 373 (9th Cir. 1995), shareholders joined an objection to a proposed settlement with the result that the district court "ultimately lowered the attorneys' fee award from $8 million to $4 million." *Id.* at 375, 377. Similarly, in *Alleghany Corp.*, 333 F.2d at 331-32, an objecting shareholder brought critical information and arguments to the district court's attention, resulting in an increase of the settlement amount from $1 million to $3 million. And, in *Rosenbaum* v. *MacAllister*, 64 F.3d 1439 (10th Cir.

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[9] *Accord Bolger*, 2 F.3d at 1313-14; *Zimmerman* v. *Bell*, 800 F.2d 386, 391 (4th Cir. 1986); Deborah A. Demott, *Shareholder Derivative Actions* § 7.02, at 7-7; Ralph C. Ferrara *et al.*, *Shareholder Derivative Litigation* § 14.05[2], at 14-23.

1995), a shareholder objector was successful in obtaining the reversal of an attorneys' fee award "equal to more than $900 per hour for every attorney, paralegal, and law clerk who worked on the case." *Id.* at 1447-48. These and other representative cases reflect that shareholder objectors make tangible and important contributions to the fairness of derivative settlements when their views are given proper consideration by the district court.[10]

II. REQUIRING SHAREHOLDER OBJECTORS TO INTERVENE TO OBTAIN APPELLATE REVIEW WOULD HINDER EFFECTIVE MONITORING OF DERIVATIVE SUIT SETTLEMENTS.

Appellate participation by shareholder objectors is critical to ensuring that derivative settlements are in the best interests of the corporation. Appellate review provides an avenue for correcting errors and creates a powerful incentive for district courts to ensure that shareholder objections are given full and fair consideration during the settlement process. By contrast, a broad ruling that shareholder objectors must intervene to secure the right to appeal a derivative settlement would erect an unnecessary and costly barrier to shareholder participation and undermine the fairness and integrity of derivative settlements without providing any offsetting benefit.

[10] *See also Bolger*, 2 F.3d at 1310 (noting case where "objectors' ardent[] resistance to the settlement persuaded [the] court to look more closely at the proposal than would normally be the case" and caused the court to reject the proposal) (internal quotation marks omitted; alteration in original); *Seigal* v. *Merrick*, 619 F.2d 160, 162-63 (2d Cir. 1980) (highlighting role of objectors in modifying settlement by providing information regarding proper valuation method).

A. Appellate Review of Shareholders' Objections Is Essential to the Effective Monitoring of Derivative Suit Settlements.

The right to appeal an adverse judgment stands as "a fundamental element of procedural fairness as generally understood in this country." ABA Comm. on Standards of Judicial Admin., *Standards Relating to Appellate Courts* § 3.10 comment. at 18 (1994). Thus, although the right to an appeal is not mandated by the Constitution, "[i]t is almost axiomatic that every losing litigant in a one-judge court ought to have a right of appeal to a multijudge court." See Robert Leflar, *Internal Operating Procedures of Appellate Courts* 4 (1976) (Leflar, *Appellate Courts*). The principal function of intermediate appellate courts is the development of the law through the correction of error. See *id.* at 3 ("[T]he task of the appellate court is to determine if prejudicial errors were committed at the trial level and to correct them."). Indeed, the general rate of reversible error by district courts is significant, and, according to the most recent statistics, the federal courts of appeals remand or reverse in approximately 15% of non-prisoner, private civil appeals. See Administrative Office of the United States Courts, *Judicial Business of the United States Courts* 100-03, Table B-5 (1997).[11]

Apart from reversal, the possibility of appellate review itself provides a powerful incentive for the district court to render more careful findings of fact and to develop a better record, producing more accurate results in the district court *ex ante*. See Steven Shavell, *The Appeals Process as a Means of Error Correction*, 24 J. Legal Stud. 379, 408-11, 425-26 (1995)

[11] *See also* Jon O. Newman, *A Study of Appellate Reversals*, 58 Brook. L. Rev. 629, 633 (1992) (reporting rate of 27% in civil cases in the Second Circuit).

(demonstrating that the appeals process "induc[es] trial court judges to make fewer errors because of their fear of reversal"). Thus, direct review not only permits appellate courts to correct errors that have already occurred, it helps to prevent future errors from occurring, and thereby ensures uniform and proper application of the law. See Leflar, *Appellate Courts*, at 4 ("[G]rowth and development in the law cannot be achieved if some courts move ahead while others hold back.").

The important functions of appellate review apply with special force in the context of settlement of shareholder derivative actions. As described in Part I, shareholder derivative suits are fraught with the potential for collusion and conflicts of interest. Once a proposed settlement has been reached, the district court no longer has the benefit of an adversarial presentation by the parties regarding the benefits and burdens of the settlement proposal. And, laboring under an ever-expanding caseload, the district court may have a natural incentive to favor quick approval of a settlement that will remove a complex case from its docket at the expense of full and careful consideration of objections. These factors work together to enhance the risk of error by the district court in fairness hearings and to reduce the likely influence of shareholder objectors at the district court level. In light of these systemic obstacles to accurate assessment of proposed settlements, appellate review is critical to ensuring the fairness of shareholder derivative settlements.

For instance, in *In re Pittsburgh & Lake Erie R.R. Co. Sec. & Antitrust Litig.*, 543 F.2d 1058 (3d Cir. 1976), plaintiff stockholders sued on behalf of a company charging that a third party (which owned 93% of the stock) had raided the company's assets. *Id.* at 1061. Prior to trial, the parties reached a settlement providing that the company would pay $2.1 million into a settlement fund, which would have gone to

plaintiffs and their lawyers. *Id.* Irving Trust Company, an objector who was a pledgee of 22.5% of the company's stock, complained that the settlement was unfair because it would transfer value from the company to the plaintiffs and their attorneys. *Id.* at 1063. The district court rejected the objections and approved the settlement. *Id.* The Second Circuit reversed, holding that Irving Trust's objections should have been sustained because the settlement provided the company with, at best, "a minimal if non-existent benefit," in exchange for its substantial $2.1 million payment. *Id.* at 1070.[12]

The availability of appeal also causes trial courts to consider the objections of shareholders more carefully in the first instance. For example, in *Girsh* v. *Jepson*, 521 F.2d 153 (3d Cir. 1975), the Third Circuit reviewed a trial court's dismissal of objections interposed by a shareholder to a proposed compromise of a class and derivative action. *Id.* at 157. At the district court level, the shareholder informed the district court of her "intention to object" and asked for an extension of time "to file papers in support of her objections." *Id.* at 156. The district court dismissed her objections and approved the settlement agreement. *Id.* The Third Circuit reversed, holding that the "district court did not live up to its fiduciary responsibilities" because it denied the objecting shareholder "meaningful participation" in the hearing. *Id.* at 158. The *Girsh* Court also set forth the proper procedures district courts should follow when reviewing a proposed settlement. *Id.* at 156-57.

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[12] *See also Rosenbaum*, 64 F.3d at 1447 (reversing award of attorneys' fees based on arguments of non-intervening shareholder objector); *In re General Motors Corp. Pick-Up Truck Fuel Tank Prods. Liab. Litig.*, 55 F.3d 768, 809-10, 812-13 (3d Cir. 1995) (reversing class action settlement where the court was too dismissive of the objectors and too willing to accept the parties' optimistic valuation of the settlement).

Since *Girsh*, other district courts have followed the factors outlined in that case (including the requirement to consider the reaction of shareholders) to guide their assessment of proposed shareholder derivative settlements. See, *e.g.*, *In re Chambers Dev. Litig.*, 912 F. Supp. at 836 (stating that the factors enunciated in *Girsh* are the "Rand-McNally" of "settlement review"). Other circuit courts have adopted similar standards through appellate decisions that guide and bind their lower courts and ensure careful consideration of and a "reasoned response" to shareholder objections. *In re Pacific Enters. Sec. Litig.*, 47 F.3d at 377 (stating that "conclusory" rejection of an objection is inadequate because the district court must "explain[] why the derivative settlement is fair"). It is only through regular appellate review of derivative settlements that such beneficial rules can be articulated and refined, and compliance with them enforced.[13]

Thus, appellate review of derivative settlements serves to correct errors that have occurred and to guide the actions of trial courts and thereby reduce the chances that errors will occur in the first place.

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[13] *See also Ficalora* v. *Lockheed Cal. Co.*, 751 F.2d 995, 997 (9th Cir. 1985) (remanding for "reasoned judgment" that the settlement "is not the product of fraud or overreaching by, or collusion among, the negotiating parties"); *City of Detroit* v. *Grinnell Corp.*, 495 F.2d 448, 463 (2d Cir. 1974) (setting forth factors relevant to the review of a proposed settlement); *cf. Malchman* v. *Davis*, 706 F.2d 426, 432, 434 (2d Cir. 1983) (reversing approval of settlement because district court failed to consider objections fully); *In re General Motors Corp. Engine Interchange Litig.*, 594 F.2d 1106, 1131 (7th Cir. 1979) ("[W]e hold that the trial court abused its discretion by failing to undertake a careful examination of the conduct of the settlement negotiations and by preventing the plaintiff-objectors from showing that the negotiations prejudiced the best interests of the class.").

B. Requiring Intervention to Secure the Right to Appeal Would Cut Off Appellate Review of Some Derivative Settlements and Erect Unfair and Unnecessary Barriers to Effective Policing of Others.

Requiring objecting shareholders to intervene formally to secure the right to appeal the rejection of their objections to a proposed derivative settlement would prevent appellate review by some objectors and increase the costs for others. Moreover, while increasing the costs of objecting to derivative suit settlements, the added burden of intervention would produce no corresponding benefit to the litigation.

1. An Intervention Requirement Would Unduly Limit and Increase the Costs of Appeals by Shareholder Objectors.

In the decision below, the Seventh Circuit acknowledged that monitoring by shareholder investors "is often useful" and that objectors' participation on appeal may "be justified." Pet. Cert. 6a. However, the court of appeals concluded that such shareholder objectors "must intervene as parties in order to appeal from adverse decisions." *Id.* at 2a. That view should be rejected.

As an initial matter, requiring intervention would *prevent* an entire category of objections from being considered on appeal because some shareholder objectors could not, as a matter of law, intervene in the action. Specifically, the "contemporaneous ownership" rule requires the representative plaintiff in a shareholder derivative action to have been "a shareholder . . . at the time of the transaction of which the plaintiff complains." Fed. R. Civ. P. 23.1; see also *Rosenbaum* v. *MacAllister*, 64 F.3d 1439, 1443 n.2 (10th Cir. 1995). To

object to a proposed compromise, however, a person "need only own stock in the corporation at the time of the settlement hearing, and appear at the settlement hearing to raise his or her objections." *Id.*; see also Ralph C. Ferrara *et al.*, *Shareholder Derivative Litigation* § 14.04, at 14-10 (noting that "the ALI's *Principles of Corporate Governance* and other courts have suggested that all shareholders of record at the time of the settlement hearing have standing to object"). As a result, the entire category of objectors who obtained their stock *after* the transaction at issue in the case — shareholder objectors who have every bit as concrete and material an interest in the district court's resolution of the proposed settlement as shareholders who satisfy the contemporaneous ownership requirement — would "be held ineligible for intervenor status" and therefore could not raise any objections on appeal. *Rosenbaum*, 64 F.3d at 1443 n.2; see *Saylor* v. *Bastedo*, 78 F.R.D. 150, 152-53 (S.D.N.Y. 1978).

In addition, another class of objectors would be unable to intervene because their intervention would destroy diversity jurisdiction over their claims. See *Strawbridge* v. *Curtis*, 7 U.S. (3 Cranch) 267, 267 (1806) (requiring complete diversity). Federal law limits the ability of such non-diverse shareholder objectors to intervene in these cases. See 28 U.S.C. § 1367(b) (barring jurisdiction over non-diverse intervenors). As the Seventh Circuit recently noted, the plain language of § 1367(b) requires that "[p]laintiffs . . . intervening under Fed. R. Civ. P. 24 must satisfy the requirements of [complete diversity]." *Stromberg Metal Works* v. *Comfort Control, Inc.*, 77 F.3d 928, 932 (7th Cir. 1996) (Easterbrook, J.); see also *Turner/Ozanne* v. *Hyman/Power*, 111 F.3d 1312, 1319 (7th Cir. 1997) ("Section 1367 precludes intervention by parties seeking to 'intervene as plaintiffs under Rule 24 . . . when exercising supplemental jurisdiction over such claims would [destroy complete diversity].").

Moreover, even for shareholders who are diverse and have standing under Rule 23.1 to intervene as plaintiffs, the right to intervene would not be assured. In contrast to the mandatory requirements in Rule 23.1, which guarantee a shareholder objector the right to receive notice and to participate at the district court level, there is no comparable guarantee that a shareholder objector who first learns of a suit through notice of a proposed (and impending) settlement will be entitled to become a formal party. Indeed, a district court's grant of intervention would be predicated on its determination that the intervening parties' interests were not adequately protected, Fed. R. Civ. P. 24(a), a determination inconsistent with the requirement that the shareholder plaintiffs "adequately represent the interests of the shareholders" from the outset. Fed. R. Civ. P. 23.1; see also 7C Charles Alan Wright *et al.*, *Federal Practice & Procedure* § 1909, at 313. Further, Rule 24's requirement of a "timely application" prejudices would-be intervenors to a derivative suit, since Rule 23.1 requires notice only upon a settlement, which is so late in the litigation process that intervention is disfavored. See, *e.g.*, *Ragsdale* v. *Turnock*, 941 F.2d 501, 504 (7th Cir. 1991) ("Once parties have invested time and effort into settling a case it would be prejudicial to allow intervention."). Thus, it is not surprising that motions to intervene often are denied in shareholder derivative cases. See generally W.J. Dunn, *Intervention by Other Stockholders in Stockholder's Derivative Action*, 69 A.L.R.2d 562, at § 2a (1960).

Finally, the costs of intervention are substantial. To intervene, a motion and supporting papers must be prepared. See Fed. R. Civ. P. 24(c). Upon intervention, an objector must file a pleading based upon reasonable investigation stating the claims or defenses that he will advance, see *id.*, and provide initial discovery disclosures pursuant to Federal Rule of Civil Procedure 26(a)(1). Thereafter, the intervenor is subject to

broad discovery from both plaintiff and defendants. See Fed. R. Civ. P. 26(b). In particular, intervenors may be required to produce detailed information relating to their ability to represent the corporation adequately.

Given the risk of collusion and conflict of interest in shareholder derivative suits, these costs are likely to be greatest in those cases where the right to appeal is most important.[14] Because shareholder objectors pose a threat to potentially unfair and collusive settlements, the parties to these suits have a strong incentive to obstruct any vigorous objection to the settlement at both the district court and appellate levels.

Indeed, the additional costs associated with intervention stand in marked contrast to the efficient procedures expressly mandated by Rule 23.1, which permit shareholders to air their objections in court *without* assuming the burdens associated with formal intervention. See Fed. R. Civ. P. 23.1. The drafters of Rule 23.1 plainly intended to entitle shareholders to present their concerns regarding a proposed settlement to the district court, free from strategic behavior or sharp litigation tactics designed to increase the cost of objection. It was precisely to avoid the risks associated with imposing additional obstacles to challenging proposed derivative settlements that the Third Circuit ruled that intervention was not required to ensure appellate rights on appeal. See *Bolger*, 2 F.3d at 1310.

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[14] Even small increases in costs imposed on the monitoring function will have a substantial effect on the incentive and ability of shareholders to restrain unfair settlements. Plaintiffs and their attorneys typically have a large stake in the settlement and can afford to litigate aggressively. By contrast, because of collective action problems endemic to derivative suits, *Bolger*, 2 F.3d at 1310, objectors act to protect only their own individual interests. Therefore, it takes only a marginal increase in litigating costs to dissuade potential objectors from participating. *Cf. id.* at 1309 ("[T]he costs of policing typically outweigh any pro rata benefits to the shareholder.")

Evidence from a related context confirms the operation of the incentives described above. Responding to similar abuses inherent in securities class actions, Congress passed the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (1995), which had as one of its purposes the goal of increasing the role of institutional investors as lead plaintiffs in class actions. See H. Conf. Rep. No. 369, 104th Cong., 1st Sess. 34 (1995), *reprinted in* 1995 U.S.C.C.A.N. 730, 733 ("Institutional investors and other class members with large amounts at stake will represent the interests of the plaintiff class more effectively than class members with small amounts at stake."). Faced with the threat of institutional investor participation, the plaintiffs' bar responded by attempting to drive up the litigation costs for institutional investors. As a result of these efforts, "[i]nstitutional investors are only rarely stepping forward to become lead plaintiffs. They are often vigorously attacked by traditional plaintiffs' counsel when they do." Joseph A. Grundfest & Michael A. Perino, *Joint Written Testimony Before the Subcommittee on Securities of the Senate Committee on Banking, Housing, and Urban Affairs* (July 24, 1997); see also *Gluck* v. *Cellstar Corp.*, 976 F. Supp. 542, 547-48 (N.D. Tex. 1997) (detailing one such struggle).

As a final note, even if respondents were correct in their suggestion that intervention would be "unhesitatingly granted" for the limited purpose of appeal, Resp. Opp. to Cert. 16, that fact would counsel against imposing an additional intervention requirement. Put simply, if every objecting shareholder were permitted to intervene to secure the right to advance his objections on appeal, then the intervention process would be an empty formality that imposes additional costs but provides no benefits to the district court or court of appeals.

2. An Intervention Requirement Would Provide No Corresponding Benefit.

The substantial costs of intervention would create an additional barrier to effective shareholder policing of derivative settlements without any corresponding benefit, either to the efficiency or to the fairness of the litigation process.

First, an intervention requirement would add nothing to the character or substance of the appeals brought by objecting shareholders. As owners of the corporation, shareholder objectors suffer a concrete injury when an unfair settlement diminishes the value of their investment; indeed, Rule 23.1 expressly solicits the views of these shareholders as a means of policing the potential abuses endemic to shareholder derivative litigation. The challenges they raise on appeal would be the same challenges raised and rejected by the district court. See *Bolger*, 2 F.3d at 1310 (holding that participation as an objector before the trial court is sufficient to permit "the same objections he now raises . . . on appeal"). There is simply no basis for concluding that shareholder objectors, who are recognized as adding value to the analysis of a settlement proposal at the district court level, are not equally well-positioned to provide guidance and insight at the appellate level.

Second, historical experience makes clear that the imposition of an intervention requirement will provide little or no benefit to appellate courts. For many years, numerous state courts and federal circuit courts have routinely allowed shareholder objectors to appeal adverse rulings without any intervention requirement. See, *e.g.*, *Rosenbaum* v. *MacAllister*, 64 F.3d 1439, 1443 (10th Cir. 1995); *Bolger*, 2 F.3d at 1307-10; *In re General Tire & Rubber Co. Sec. Litig.*, 726 F.2d 1075, 1087 (6th Cir. 1984) (affirming denial of intervention but addressing shareholder's objections on appeal); *In re Pittsburgh*

& Lake Erie R.R. Co. Sec. & Antitrust Litig., 543 F.2d 1058, 1064 (3d Cir. 1976) (holding that objector has standing to appeal); *Tryforos* v. *Icarian Dev. Co.*, 518 F.2d 1258, 1263 n.22 (7th Cir. 1975) (Stevens, J.) (stating that the "law is clear" that non-party objectors may appeal); *Braun* v. *Fleming-Hall Tobacco Co.*, 92 A.2d 302, 308 (Del. Ch. 1952) (reviewing appeal of non-intervening objector). There is no evidence in these jurisdictions of a proliferation of meritless appeals or "unwieldy" appellate litigation of settlement objections. Indeed, requiring intervention would create an extra layer of largely wasteful appeals from the denial of intervention.

Third, cases from other contexts have acknowledged the appellate rights of non-parties whose interests have been concretely and adversely affected by the decision of the district court. There is a long pedigree of cases that "clearly establish that nonparties can achieve standing to appeal." 15A Charles Alan Wright *et al.*, *Federal Practice & Procedure* § 3902.1 at 132; see also Timothy A. Duffy, Comment, *The Appealability of Class Action Settlements by Unnamed Parties*, 60 U. Chi. L. Rev. 933, 940-41 (1993) (describing deep-rooted common-law origins of right of unnamed class members to appeal). The readiest example is that of an appellant, not a party, who has nevertheless been enjoined, held in contempt, or otherwise directly affected by an order of the district court. See, *e.g.*, *United States Catholic Conference* v. *Abortion Rights Mobilization, Inc.*, 487 U.S. 72, 76 (1988) ("The right of a nonparty to appeal an adjudication of contempt cannot be questioned."); *Thompson* v. *Freeman*, 648 F.2d 1144, 1447 n.5 (8th Cir. 1981) (holding that non-party may bring "appeal to contest the district court's jurisdiction to bind it to the terms of the court's injunction"). Similarly, when a party is denied statutory attorney fees by the district court, that party's attorney has standing to appeal. See, *e.g.*, *Lipscomb* v. *Wise*, 643 F.2d 319, 320 (5th Cir. 1981); *Dietrich Corp.* v. *King Resources*

Co., 596 F.2d 422, 424 (10th Cir. 1979). In *Dietrich*, the court noted that intervention was irrelevant to appellate rights; the controlling factor was that denying the attorney the right to appeal would render the district court's determination unreviewable. See *id.* In *Lipscomb*, the fees were sought pursuant to 42 U.S.C. § 1973*l*(e), and the court of appeals concluded that if the statutory provision of fees were to have any meaning, the non-party whose interest was implicated must be able to seek appellate review. *Lipscomb*, 643 F.2d at 320-21.

The same is true here: If objecting non-party shareholders are not entitled to appeal after their objections lodged under Rule 23.1 have been rejected, then the concrete and important interests they represent will never receive an appellate hearing. The consequence of such a requirement would be more collusive and unfair derivative settlements. As Congress and the drafters of the Federal Rules of Civil Procedure were plainly of the view that objecting shareholders could make valuable contributions to district court review of such settlements, there is no sound reason in law or policy to bar or discourage them from playing a similar role on appeal.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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